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In the Supreme Court of the United States

OCTOBER TERM, 1969

No.

UNITED STATES OF AMERICA, PETITIONER

v.

MACLIN P. DAVIS AND EDITH U. DAVIS

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINION BELOW

The opinion of the district court (R. 33a–42a) [1] is reported at 274 F. Supp. 466. The opinion of the court of appeals (App. A, *infra*, pp. 11–19) is not yet reported.

JURISDICTION

The judgment of the court of appeals was entered on March 27, 1969 (App. B, *infra*, p. 21). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

[1] "R" refers to the printed record in the court of appeals entitled "Appendix B to Brief for the Defendant-Appellant".

QUESTION PRESENTED

Whether the redemption by a corporation of all of its preferred stock from the respondent, who was also the actual or constructive owner of all of the corporation's common stock, resulted in a corporate distribution which was essentially equivalent to a dividend within the scope of Section 302(b)(1) of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 301, 302, 316 and 318 of the Internal Revenue Code of 1954 and Section 1.302–2 of the Regulations thereunder are set forth in Appendix C. *infra,* pp. 23–27.

STATEMENT

Respondent and E. B. Bradley organized Tennessee Foundry and Machine Company in 1945. Prior thereto, respondent had entered into negotiations for a $95,000 loan to the corporation. The prospective lenders, the Reconstruction Finance Corporation and a bank, had agreed to make the loan only if respondent and Bradley provided the corporation with an additional $25,000 of working capital either by making a loan evidenced by a subordinated deferred note or by purchasing preferred or additional common stock. Bradley was unable or unwilling to invest additional capital but insisted on retaining 50 per cent of the voting power. As a result, the only methods of raising the additional capital considered were that respondent would either purchase preferred stock or take subordinated debentures in exchange for a loan. Upon approval of the loan application by the Reconstruction

Finance Corporation, respondent purchased 1,000 shares of six percent preferred stock at a par value at $25 per share. Thus, on the date of incorporation or shortly thereafter, respondent held all the preferred stock, he and his wife held 50 percent of the 1,000 shares of common stock and Bradley held the other 50 percent of the common (R. 33a–34a.)

In 1952 respondent purchased Bradley's 500 shares of common stock, and in 1959 transferred 250 of these shares to his son, M. P. Davis, Jr., and 250 shares to his daughter, Edith D. Whiteman. As a consequence, respondent, his wife, daughter and son held all the common stock and respondent held all the preferred stock (R. 35a).[2]

On September 23, 1963, after final payment on the loan had been made, the corporation's board of directors resolved to redeem the preferred stock by accepting respondent's offer to transfer these shares in exchange for the sum of $25,000. On October 1, 1963, respondent surrendered the certificate representing the stock and was paid $25,000. (R. 35a.)

For income tax purposes respondent treated the $25,000 as a sale of preferred stock resulting in no gain to him because his basis for the stock was $25,000. Upon audit, the Internal Revenue Service determined that the $25,000 was a distribution that was essentially equivalent to a dividend and therefore

[2] "Respondent" refers to Maclin P. Davis. His wife is a party because joint returns were filed for the tax year in question. Under Section 318(a) of the Code, the respondent is treated as owning all of these shares. See p. 9, below.

taxable as ordinary income.[3] Respondent paid the resulting deficiency and later instituted this suit for refund.[4] (R. 36a.) The district court decided the issue in favor of the respondent and the Sixth Circuit affirmed. (R. 36a–42a, App. A, *infra*, pp. 11–20.)

REASONS FOR GRANTING THE WRIT

The decision below is part of a multi-dimensional conflict in the interpretations the courts of appeals have given Section 302(b)(1) of the Internal Revenue Code of 1954. The issue is a continually recurring one in the administration of the Code provisions which affect closely held corporations. This court must resolve the conflict if confusion in this area of the tax law is to be eliminated and if even-handed treatment of similarly situated taxpayers is to be achieved.

1. Sections 301 and 316 of the Internal Revenue Code of 1954 require that distributions of corporate property to shareholders be treated as dividends, taxable at ordinary income rates to the extent of accumulated corporate earnings and profits, unless the distribution can be brought within some specific statutory exception. See *e.g., Commissioner* v. *Gordon,* 391 U.S. 83, 89. The ultimate question here is whether Tennessee Foundry's

[3] Under the Service's view of the transaction, respondent's basis in his preferred stock should now be reflected by an appropriate adjustment in the basis of petitioner's common stock. See Regulations on Income Tax (1954 Code) § 1.302–2(c) and the examples thereunder.

[4] There is no claim that the redemption of respondent's preferred stock resulted in a contraction of the business or in any other fashion qualified for capital gains treatment as a partial liquidation under Section 346 of the Code. The only distribution was of cash out of earnings.

redemption of respondent's preferred stock comes within the exception defined in Section 302 of the Code (App. C, *infra*, pp. 23–24).

Section 302(a) states that a corporate stock redemption "shall be treated as a distribution * * * in exchange for the stock"—that is, shall be given capital treatment—if the redemption qualifies under one of the four subparagraphs of Section 302(b). This case is concerned only with Section 302(b)(1), which provides that a redemption shall be treated as a distribution in exchange for stock "if the redemption is not essentially equivalent to a dividend."[5]

The question presented here is, in substance, the extent to which the "business purpose" attending the redemption is to be considered in determining whether the redemption is essentially a dividend. The position of the Commissioner of Internal Revenue is that business purpose is immaterial, and that there is dividend equivalence if the redemption is pro rata to each shareholder's interest in a corporation.

2. With the decision below, seven courts of appeals have considered the issue which this case presents. The result has been at least four distinct attitudes towards the significance to be accorded the purpose of a redemption. Only the Second Circuit has accepted with-

[5] The other three categories of qualifying redemptions are those (Section 302(b)(2)) that are "substantially disproportionate" to the shareholder's interest in the corporation; a redemption (Section 302(b)(3)) of all of the shareholder's stock; and a redemption (Section 302(b)(4)) of the stock of certain railroad corporations. See, generally, Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed. 1966) 279–300.

out qualification the Commission's position which has become known as the "strict" net effect test. See *McGinty* v. *Commissioner*, 325 F. 2d 820 (C.A. 2); *Hasbrook* v. *United States*, 343 F. 2d 811 (C.A. 2); *Levin* v. *Commissioner*, 385 F. 2d 521 (C.A. 2). Two other circuits, the Ninth and Tenth, apply a so-called "flexible" net effect test, under which business purpose is considered as a factor militating against dividend equivalence. *Kerr* v. *Commissioner*, 326 F. 2d 225 (C.A. 9); *Tabery* v. *Commissioner*, 354 F. 2d 422 (C.A. 9); *Commissioner* v. *Berenbaum*, 369 F. 2d 337 (C.A. 10). The Eighth Circuit seems to have a third approach, which treats the question of dividend equivalence as entirely one of fact[6] while at the same time holding that a bona fide business purpose does not require a holding for the taxpayer. See *Heman* v. *Commissioner*, 283 F. 2d 227 (C.A. 8). The Fifth Circuit has expressed a similar view as to the significance of business purpose. *United States* v. *Fewell*, 255 F. 2d 496, 500 (C.A. 5).

It is unclear what rule applies in the First and Fourth Circuits. The First Circuit first adopted the "flexible" net effect test but now appears to be working toward the Second Circuit's view. Compare *Keefe* v. *Cote*, 213 F. 2d 651 (C.A. 1), with *Bradbury* v. *Commissioner*, 298 F. 2d 111 (C.A. 1). The Fourth Circuit, in contrast, first seemed to approve the "strict" net effect test, although in dicta, but in a more recent decision has apparently changed its position. Compare *Ballenger* v. *United States*, 301 F. 2d

[6] Compare the Ninth Circuit's statement in *Kerr* (326 F. 2d at 229) and *Tabery* (354 F. 2d at 427), that the question is "a mixed question of law and fact, if not purely a conclusion of law." This problem is not involved in this case.

192 (C.A. 4), with *Commissioner* v. *Estate of Antrim*, 395 F. 2d 430 (C.A. 4).

3. The decision of the Sixth Circuit in this case reflects yet another approach. While purporting to adhere to the "flexible" net effect test, the court did not find or rest on any business purpose attending the redemption of respondent's stock in 1963. Rather, it looked into the purposes of the issuance of that stock in 1945. Its conclusion that respondent should have capital treatment rested on two factual conclusions: (1) that the purpose of issuing the preferred stock was to meet the RFC's requirement that the shareholders provide greater working capital (App. A, *infra*, p. 12); and (2) that Tennessee Foundry (*id.*, p. 17) "had always intended to redeem Taxpayer's preferred stock when the [RFC] loan was paid off."

In thus looking (*ibid.*) "to the point in time when Taxpayer contributed the $25,000," the Court below is in direct conflict with the Fourth Circuit's decision in *Ballenger* v. *United States*, *supra*, and the Tenth Circuit in *Commissioner* v. *Berenbaum*, *supra*. Although *Ballenger* seems to reject the "flexible" net effect test and *Berenbaum* seems to accept it, both decisions hold that the business purpose for the issuance of preferred stock is not material in determining whether the later redemption is essentially equivalent to a dividend. Thus, in *Ballenger*, the Fourth Circuit stated (301 F. 2d at 199) that "we cannot understand how a valid reason for the issuance of preferred stock can, once its purposes have been served, be converted into a reason for its redemption"; and the Tenth Circuit has said much the same.

The facts of *Berenbaum* are strikingly similar to this case. There the preferred stock had been issued to increase the corporate capital as a condition to an FHA mortgage transaction. In *Ballenger,* the preferred stock was allegedly issued subject to the directions of a probate court, to protect the interest of the widow and child of a deceased former partner in the business, a purpose that for present purposes is indistinguishable from that relied on below.

4. The "strict" net effect test applied by the Second Circuit is in harmony with the Congressional intent with respect to the application of Section 302(b)(1). The decisions below and in the other courts of appeals which apply one of the variations of the "flexible" net effect test are wrong, in our view. Although cases decided under the Internal Revenue Code of 1939 may provide some support for the "flexible" test, use of the flexible test ignores the fact that Congress, in adopting the 1954 Code, "substantially recast the law in this field" (*Ballenger* v. *United States, supra,* 301 F. 2d at 194 (C.A. 4)) by laying down precise guidelines, or "safe harbors," for taxpayers seeking capital gain treatment. As the Second Circuit indicated in *Levin* v. *Commissioner,* 385 F. 2d 521, the 1954 legislative history of that section shows that Congress had an exceedingly narrow purpose in incorporating certain language of the 1939 Code into Section 302(b)(1).

As drafted by the House, the 1954 Code would have dropped the 1939 language and included only the present Sections 302(b)(2), (3), and (4). The Senate added Section 302(b)(1), but apparently to allow only

for such occurrences as the "redemption of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place." S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 44–45. As the leading commentators in the field observed, "It is not easy to give § 302 (b)(1) an expansive construction in view of this indication that its major function was the narrow one of immunizing redemptions of minority holdings of preferred stock." Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed. 1966) 291.

Notwithstanding this history, the court below found a lack of dividend equivalence in the most obvious dividend equivalence situation, *i.e.*, one where the redemption of stock is from the actual or constructive owner of all of the corporation's stock, both common and preferred. Section 318(a) of the Code, which is incorporated by reference into Section 302 (see Section 302(c)), requires that respondent "be considered as owning the stock owned * * * by * * * his spouse * * * and * * * his children * * *." In consequence, in determining whether the redemption of respondents' preferred stock comes within Section 302(b)(1), he is deemed the holder of all the outstanding stock of Tennessee Foundry. The redemption of the preferred stock of the sole shareholder is the opposite of what Congress had in mind in adopting Section 302(b)(1). The redemption therefore should be treated as a dividend, under Section 301, and not as a distribution in exchange for the stock, under Section 302.

5. As the number of appellate decisions of the last

several years indicates, the question in this case constantly recurs.[6] It has proved to be one of the most confused in tax litigation. Seldom has a tax problem produced such diversity of opinion among the courts of appeals.

This, moreover, is a question that particularly calls for a unitary resolution. It affects the planning of capital transactions in closely held corporations, and it is essential that tax practitioners and the Treasury have a settled rule whose application may safely be foreseen before a redemption is undertaken. This objective can be achieved and the confused state of the authorities can be put to rest only through review by this Court.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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JUNE 1969.

[6] We are aware of some 35 other cases pending in the courts which involve the application of Section 302(b)(1). The "business purpose" question has, to date, been raised in 15 of these cases. We have not been able to determine how many similar cases are pending at the administrative level.

APPENDIX A

No. 18487

In the United States Court of Appeals for the Sixth Circuit

MACLIN P. DAVIS AND EDITH U. DAVIS, PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

On Appeal from the United States District Court for the Middle District of Tennessee

Decided March 27, 1969

Before: O'SULLIVAN and CELEBREZZE, *Circuit Judges* and MCALLISTER, *Senior Circuit Judge.*

CELEBREZZE, Circuit Judge. The Government appeals a judgment of the United States District Court for the Middle District of Tennessee granting Taxpayer's [1] claim for refund of federal income taxes. The cause was heard on motions for summary judgment filed by both parties. On denial of its motion for rehearing the Government perfected this appeal. The

[1] Appellees filed a joint return. The designation "Taxpayer" throughout this opinion, however, shall refer to Maclin P. Davis.

question before us is whether a corporate distribution to Taxpayer, in redemption of all his preferred stock in the Corporation, was essentially equivalent to a dividend under Section 302(b)(1) of the Internal Revenue Code of 1954.[2]

In 1945, Taxpayer and one Bradley organized the Tennessee Foundry & Machinery Company (hereinafter Corporation) to manufacture steel castings. In exchange for equipment transferred to the Corporation, Bradley and Taxpayer each received fifty percent of its common stock. Prior to incorporation, Taxpayer had begun negotiations with the Reconstruction Finance Corporation (hereinafter RFC) for the purpose of obtaining a $95,000 loan to the Corporation. RFC agreed to make the loan on the condition that the incorporators provide the Corporation with additional working capital in the amount of $25,000. Bradley insisted on retaining his fifty percent of the voting power but was unwilling to invest any additional capital. In order to meet the demand of RFC, Taxpayer contributed the $25,000 in exchange for one hundred shares of six percent non-voting preferred stock with a par value of $25 per share. Taxpayer contended and the District Court found that the sole purpose of the transaction was to enable the Corporation to obtain the RFC loan and that the preferred

[2] "Sec. 302. Distributions in Redemptions of Stock.

"(a) General Rule.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

"(b) Redemptions Treated as Exchanges.—

"(1) Redemptions not equivalent to dividends.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend."

stock was to be redeemed when the loan was repaid. Thus, on the date of incorporation the capital structure of the Corporation was as follows:

	Common—%	Preferred—%
Bradley	500–50	
Taxpayer	250–25	1,000—100%
Taxpayer's Wife	250–25	

In 1952, Taxpayer purchased Bradley's common stock and in 1959 he transferred 250 shares to his son and 250 shares to his daughter. The original loan agreement provided that so long as part of the RFC loan was outstanding, no dividends could be paid without obtaining the written consent of RFC. Such permission was granted in 1960 and semiannual dividends were paid beginning on October 5th of that year.

On June 1, 1963 the loan was paid off and on September 23, 1963 the Corporation voted to redeem Taxpayer's preferred stock. On October 1, 1963 this stock was redeemed for $25,000, the amount Taxpayer paid for it. On this date the capital structure of the Corporation, reflecting the prior purchase of Bradley's shares by Taxpayer, was as follows:

	Common—%	Preferred—%
Taxpayer	250–25	1,000
Wife	250–25	
Son	250–25	
Daughter	250–25	

The Commissioner contended that the $25,000 was "essentially equivalent to a dividend" within the meaning of Section 302(b)(1) of the Code, hence tax-

able as ordinary income under Section 301 of the Code.[3] The District Court held to the contrary and granted Taxpayer's claim for refund. We affirm the judgment of the District Court.

Section 302 of the Code provides capital gains treatment to corporate distributions made in redemption of stock. The transaction is treated as a sale or exchange of a capital asset and gain is realized to the extent that the distribution exceeds a taxpayer's cost basis for the stock. Here, Taxpayer received back his cost basis for the stock so he had no gain. On the other hand, corporate distributions amounting to dividends are includable in their entirety in gross income and taxed at ordinary rates. Where the question is whether a particular corporate distribution is a redemption or dividend Section 302 provides several tests for determining the answer.[4] Since the Corporation was not liquidating its business and the stock redeemed was preferred stock with no voting rights, our inquiry is limited to Section 302(b)(1) which simply states the principle that a corporate distribution in exchange for stock is not a redemption if it is essentially equivalent to a dividend.[5]

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[3] Section 301(c) of the Code provides that gross income includes dividends. Section 316 of the Code defines a "dividend" generally as a distribution of property made by a corporation to its shareholders out of earnings and profits.

[4] Similar rules are contained throughout Code Sections 301-318 (distributions by corporations other than liquidating distributions) and Code Sections 331-346 (liquidating distributions.)

[5] By contrast, Subsections (2), (3), and (4) of Section 302 (b) contain objective tests for determining whether the distribution was a redemption. Subsection (2) provides that substantially disproportionate distributions with respect to the shareholder are to be treated as redemptions under Section 302(a).

We therefore look to the facts as found by the District Court to determine whether the distribution in issue was equivalent to a dividend. See *Ballenger* v. *United States,* 301 F. 2d 192 (4th Cir. 1962). The standard contained in Section 302(b)(1) calls for a factual resolution of the question and has been so used by the courts and the Commissioner. *Rheinstrom* v. *Commissioner,* 125 F. 2d 790 (6th Cir. 1942), cert. denied 317 U.S. 654; *Cobb* v. *Calan Court Co.,* 274 F. 2d 532 (5th Cir. 1960); *Colvin* v. *United States,* 175 F. Supp. 877 (S.D. Cal. 1959); Treasury Regulation 1.302-2(b). Our function on review is to determine whether the District Court applied the correct criteria to those facts. *Ballenger,* supra; but see *Pacific Vegetable Oil Co.* v. *Commissioner,* 251 F. 2d 682 (9th Cir. 1957) (dividend equivalency is mixed question of fact and law).

The purpose of the various tests in Section 302(b) of the Code is to prevent tax avoidance, more specifically, to prevent corporations from bailing out earnings to shareholders at favorable capital gains rates. To bring some objectivity to Section 302(b)(1), the Courts have established some guidelines which when applied to the facts of each case are calculated to determine whether a particular corporate distribution is in fact a dividend. Under the "strict net effect" test, if the taxpayer ends up in the same position after the distribution as he would have occupied

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By a limitation contained in that subsection, however, the shareholder must after the distribution end up with less than 50% of the total combined voting power in the corporation. Subsection (3) provides that a shareholder's stock is considered to be redeemed under Section 302(a) when he terminates his interest in the corporation. Subsection (4) deals with railroad corporations. This leaves for our consideration Subsection (1) of Section 302(b).

had a dividend been declared, the net effect of the transaction is held to be the payment of a dividend. See, *e.g., Commissioner* v. *Estate of Bedford,* 325 U.S. 283 (1945); *Levin* v. *Commissioner,* 385 F. 2d 521 (2d Cir. 1967). Applying the strict net effect test in the way that the Government urges, in 1963, Taxpayer—because of the attribution rules of Section 318[6] of the Code—would be considered as owning all of the common stock of the Corporation so the distribution to him in payment for his preferred stock was made pro rata on his common stock. The Government contends that a pro rata distribution by a corporation effecting no basic change in shareholder relationships is the hallmark of a dividend, therefore the payment to Taxpayer was "essentially equivalent to a dividend" and taxable as such. *Himmel* v. *Commissioner,* 388 F. 2d 815 (2d Cir. 1964); *Kerr* v. *Commissioner,* 326 F. 2d 225 (9th Cir. 1964) cert. denied 377 U.S. 963.

[6] Section 318(a)(1) makes Taxpayer the constructive "owner" of the common stock owned by his spouse and children. Since his spouse and children each owned 25% of the remaining 75% of the common stock of the Corporation, Taxpayer winds up with 100% of the common stock. Section 318(a) is made applicable to Section 302 generally by Subsection (c)(1) of Section 302. But whether the attribution rules apply specifically to Section 302(b)(1) has caused some controversy. See, *e.g.*, Comment, 47 Minn. Law Rev. 853, 867–70 (1963). The District Court held that they do apply to Section 302(b)(1). We agree to the extent that constructive ownership of stock may be used as a factor to determine whether the distribution in question is in reality a dividend. See Treas. Reg. 1.302–2(b). But, like the flexibility given to the strict net effect test, there may be situations where it would be unrealistic to apply the attribution rules in strict fashion, for instance in cases of family estrangement. *Levin* v. *Commissioner*, 385 F. 2d 521 (2d Cir. 1967); *Himmel* v. *Commissioner*, 338 F. 2d 815 (2d Cir. 1964).

The District Court, however, looked to the entire transaction and applied the "flexible net effect" test. Under this test, a business purpose for the redemption will temper the conclusiveness of a strict net effect result. See *Keefe* v. *Cote,* 213 F. 2d 651 (1st Cir. 1954). The Court looked to the point in time when Taxpayer contributed the $25,000 and found that the Corporation had always intended to redeem Taxpayer's preferred stock when the loan was paid off. We are aware that use of "busines purpose" to mollify the rigors of the strict net effect test has been criticized, see, *e.g., Levin* v. *Commissioner,* 385 F. 2d 521 (2d Cir. 1967), even by the First Circuit which purports to follow it. *Bradbury* v. *Commissioner,* 298 F. 2d 111 (1st Cir. 1962). Many courts, however, give it some weight. See *United States* v. *Fewell,* 255 F. 2d 496 (5th Cir. 1958); *Commissioner* v. *Berenbaum,* 369 F. 2d 337 (10th Cir. 1966); *Phelps* v. *Commissioner,* 247 F. 2d 156 (9th Cir. 1957); *Colvin* v. *United States,* 175 F. Supp. 877 (S.D.Cal. 1959); *Estate of Golwynne,* 26 T.C. 1209 (1956). In any event, the "strict net effect" test and the "flexible net effect" test complement each other in this respect: to the extent that the facts show a business purpose for the redemption there is an absence of the proscribed tax avoidance purpose to bail out dividends at favorable tax rates. See *Ballenger* v. *United States,* 301 F. 2d 192, 198 (4th Cir. 1962).

The Government concedes that there would be no issue of dividend equivalency here had the Corporation redeemed Taxpayer's preferred stock while Bradley owned fifty percent of the Corporation's common stock. A redemption of any of Taxpayer's preferred stock at such time would not have been a pro rata distribution on the Corporation's common stock. Nevertheless, armed with the strict net effect

test the Government contends that Taxpayer's subsequent acquisition by way of attribution under Section 318(a) of the Code of one hundred percent control of the Corporation converted the distribution to him in payment for his preferred stock into a dividend paid pro rata on the common stock. To expand upon the Government's argument, Taxpayer was precluded from withdrawing his $25,000 investment intact because his decision to buy out Bradley's interest and acquire control of the Corporation converted what would have been a straight stock redemption into a tax-avoidance scheme to bail out corporate earnings. We do not believe Congress intended that Section 302 of the Code should work such a harsh result especially since the primary purpose of capital gains treatment is to encourage individuals to risk capital for investment purposes. Although closely-held corporations call for close scrutiny under the tax law, we will not, under the facts and circumstances of this case, allow mechanical attribution rules to transform a legitimate corporate transaction into a tax avoidance scheme.

A transaction involving Section 306 of the Code illustrates the converse situation. Under that Section, preferred stock or its equivalent is treated for income tax purposes as a cash dividend where the preferred stock was originally distributed as a stock dividend pro rata on the outstanding common stock. Section 306(c)(1)(A) Internal Revenue Code of 1954. Under Section 305 of the Code stock dividends are not taxable. When Section 306 preferred stock is sold or redeemed, the payment for it is taxable at ordinary income rates unless the shareholder has at the same time terminated his interest in the corporation.[7] Before the enactment of Section

[7] Section 306 adopts the termination criterion of Section 302(b)(3) of the Code. See footnote 5, supra.

306, the use of the "preferred stock bail out" was a popular tax avoidance device and Section 306 was intended to eliminate it. Section 306 stock, however, does not lose its cash dividend character if the holder disposes of all or part of his common stock. Section 302(b)(3); cf. *Himmel* v. *Commissioner,* 338 F. 2d 815 (2d Cir. 1964). Likewise, Taxpayer's preferred stock did not become a cash dividend coverup even if the attribution rules are applied from the date he bought Bradley's common stock.

The facts of this case demand that substance win over form and that the entire transaction control the tax effect of the stock redemption in issue. As the District Court stated:

> "The subsequent acquisition of Bradley's stock holdings by taxpayer, making the redemption distribution essentially pro rata because of the § 318(a) attribution rules, neither impairs the legitimacy of the purpose underlying the issuance of the preferred stock [to provide additional security required by RFC] nor alters the fact that the redemption was simply the final [contemplated] step taken in completion of this purpose."

We conclude that the District Court was, under the facts and circumstances in this case, correct in holding that the redemption by the Corporation of Taxpayer's preferred stock was a distribution made in exchange for his stock and not a distribution that was "essentially equivalent" to a dividend.

Affirmed.

APPENDIX B

In the United States Court of Appeals for the Sixth Circuit

No. 18,487

MACLIN P. DAVIS AND EDITH U. DAVIS,
PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Before: O'SULLIVAN and CELEBREZZE, *Circuit Judges,* and MCALLISTER, *Senior Circuit Judge.*

JUDGMENT

Appeal from the United States District Court for the Middle District of Tennessee

This cause came on to be heard on the record from the United States District Court for the Middle District of Tennessee and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby affirmed.

It is further ordered that Plaintiff-Appellee recover from Defendant-Appellant the costs on appeal, as itemized below, and that execution therefor issue out of said District Court.

Entered by order of the Court.

CARL W. REUSS, *Clerk.*

Filed March 27, 1969.

APPENDIX C

Statute and Regulation Involved

Internal Revenue Code of 1954:

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) *In General.*—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * * *

[26 U.S.C. 301.]

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) *General Rule.*—If a corporation redeems its stock (within the meaning of section 317 (b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions Treated as Exchanges.*—

(1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) *Substantially disproportionate redemption of Stock.*—

* * * * *

(3) *Termination of shareholder's interest.*—

(4) *Stock issued by railroad corporations in certain reorganizations.*—* * *

(5) *Application of paragraphs.*—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of pargraph (2), (3), or (4) shall not be taken into account. * * *

(c) *Constructive Ownership of Stock.*—

(1) *In general.*—Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section.

* * * * *

(d) *Redemptions Treated as Distributions of Property.*—Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

* * * * *

[26 U.S.C. 302.]

SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.*—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. * * *

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[26 U.S.C. 316.]

SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK.

(a) *General Rule.*—For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

(1) *Members of family.*—

(A) *In General.*—An individual shall be considered as owning the stock owned, directly or indirectly, by or for—

(i) his spouse * * *, and

(ii) his children, * * *.

* * * * *

[26 U.S.C. 318.]

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.302–2 *Redemptions not taxable as dividends.*

(a) The fact that a redemption fails to meet the requirements of paragraph (2), (3) or (4) of section 302(b) shall not be taken into account in determining whether the redemption is not essentially equivalent to a dividend under section 302(b)(1). See, however, paragraph (b) of this section. For example, if a shareholder owns only non-voting stock of a corporation which is not section 306 stock and which is limited and preferred as to dividends and in

liquidation, and one-half of such stock is redeemed, the distribution will ordinarily meet the requirements of paragraph (1) of section 302(b) but will not meet the requirements of paragraph (2), (3) or (4) of such section. The determination of whether or not a distribution is within the phrase "essentially equivalent to a dividend" (that is, having the same effect as a distribution without any redemption of stock) shall be made without regard to the earnings and profits of the corporation at the time of the distribution. For example, if A owns all the stock of a corporation and the corporation redeems part of his stock at a time when it has no earnings and profits, the distribution shall be treated as a distribution under section 301 pursuant to section 302(d).

(b) The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a). All distribution in pro rata redemptions of a part of the stock of a corporation generally will be treated as distributions under section 301 if the corporation has only one class of stock outstanding. However, for distributions in partial liquidation, see section 346. The redemption of all of one class of stock (except section 306 stock) either at one time or in a series of redemptions generally will be considered as a distribution under section 301 if all classes of stock outstanding at the time of the redemption are held

in the same proportion. Distribution in redemption of stock may be treated as distributions under section 301 regardless of the provisions of the stock certificate and regardless of whether all stock being redeemed was acquired by the stockholders from whom the stock was redeemed by purchase or otherwise. In every case in which a shareholder transfers stock to the corporation which issued such stock in exchange for property, the facts and circumstances shall be reported on his return except as provided in paragraph (d) of § 1.331–1. See sections 346(a) and 6043 for requirements relating to returns by corporations.

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[26 C.F.R. 1.302–2.]

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